Startup Bootcamp 101

Resources & Information For Founders & Startups Regarding Legal, Finance, & Related Issues

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Introduction

So you developed the next big app or social media website idea, formed an entity, and developed a business plan, now how do you get funding, form an entity, etc?

This book will explain in layman's terms some of the things that every founder should know about the types of equity and how common forms of funding relate to your company's equity. I am also using a C corporation for the discussion relative to equity structures, so this doesn't necessarily apply if you formed an LLC (limited liability company) or other type of entity.

I) Forms of equity (ownership interest in the company)

Founder's Stock- This is a generic term often used when dealing with start up companies. This is the stock issued by the company to the founder's of the company. The most common way this occurs is that the corporation is formed and then there is a corporate resolution to issue a portion of the corporation's authorized stock to the people who started the company. They are usually issued in exchange for the founder's initial services to start the company, for technology assigned to or developed for the company, or for some other thing of value, such as cash provided to the company. It is pretty typical that a company issues common stock as founder's stock versus preferred stock. It is usually no different than any other type of common stock issued by the company, other than it was issued to those who founded the company.

The company will usually place some kind of restriction on founder's stock, such as a vesting schedule over time, but that is not required. This usually includes a right of repurchase or other clauses that deal with unvested stock. These are usually put in place to avoid potentially negative tax consequences from deferred compensation. Just because there is a vesting for founders' stock, doesn't mean they are not trusted or for some other reason, but can often be to protect a founder from these adverse tax consequences.

The initial amounts of stock used for founder's stock and otherwise are determined by the company's "capitalization." This just means the total equity structure of the company, e.g. Company A has 1,000,000 shares of common stock authorized, 500,000 shares issued to founders with no one else owning any other form of shares or options to purchase shares. The founders would own 100% of the company even though the company can still issue more shares.

Common Stock- This is the general basic form of equity (ownership interest) in a corporation. It is represented by a physical stock certificate (or, in some cases, in electronic form with a broker). It shows the name of the person or entity owning the stock, number of shares, name of the corporation, and sometimes other info like date of issuance, signatures by corporate officers, number of authorized shares of the corporation. It is issued for many different reasons: to founders (see above), for funding, as compensation for services, etc.

Many people want to know, how much of the company do I own, i.e. what percent. In the capital structure of most corporations with only common stock, there are a certain number of shares authorized to be issued by the corporation, which is typically found in places like the articles of incorporation, board resolutions, or in documents filed with the secretary of state in the state of incorporation. Authorized shares are the pool of available stock the company can issue to people now or in the future. The number of shares actually issued to people is the amount of stock outstanding. So, if there are 100 shares authorized, but only 10 shares issued, only 10% of the potential ownership of the corporation has been issued. If you own 10 shares of the corporation, right now you own 100% of the company. If the company issues another 90 shares to someone else, you now only own 10% of the company's now issued 100 shares of stock. When seeking equity funding, you are selling a portion of the company's shares of stock. This almost always results in you owning less of the company. The only way to keep your percentage the same would be to sell them the stock you own (not the company issuing new stock) or for the company to issue you more shares of stock to keep your total percentage of the company the same (called anti-dilution, so you are not "diluted" down). Now most investors are not going to want to line your personal pockets by buying your personal stock, they want to help the company grow and get a percentage ownership and they are usually going to require that you be diluted down.

Don't always assume you are losing control of "your" company or that you are getting screwed. First, a corporation is a separate legal entity owned by its shareholders, so although you may own 100% of the shares right now, it is best to get out of the habit of thinking it is "your" company. Also for control, take the example of Mark Zuckerberg who was diluted down in Facebook (although surprisingly not much) and he did just fine. He still maintains control of the company through board seats and voting agreements/proxies, but that is another topic entirely. You will be diluted down and probably lose 100% control over the company, but if you want to get funded, it is part of the deal, especially in the VC world.

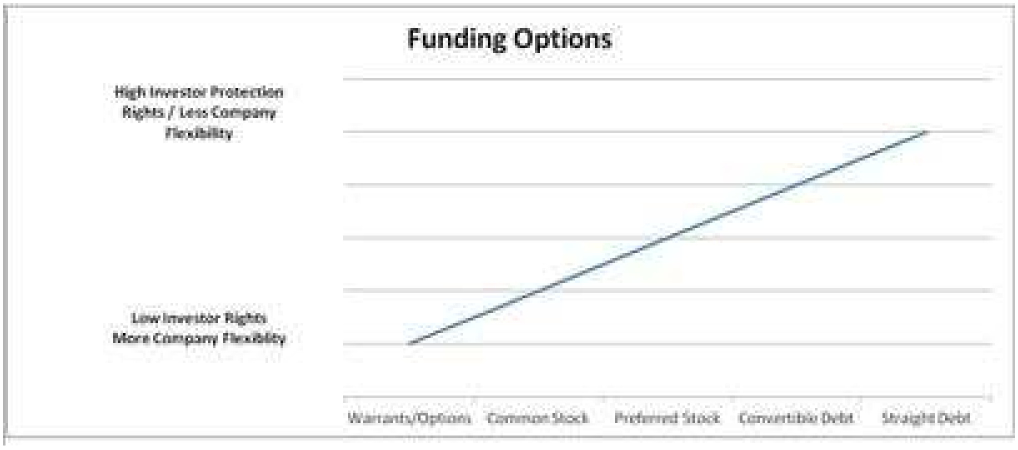
Restricted Stock- This is a designation that can apply to any type of stock and usually the specific restriction is required to be printed on the physical stock certificate so that the shareholder knows about it. It usually means that the stock has some form of restrictions on transfer, meaning you can't just easily sell it without complying with those restrictions. Common stock, founder's stock, or preferred stock could all potentially be restricted stock (any usually is). If you go onto your online stock brokerage account and buy 100 shares of Microsoft, you are buying freely trading, unrestricted common stock. In other words, there are no restrictions on transfer. In most cases with startups, the initial stock is going to be restricted. You can only sell the stock after it is registered with the SEC ("goes public") or there is an exemption that allows you to sell. SEC Rule 144 is a rule that has to do with the holding period that you must hold the restricted stock before it can become free trading stock.

Preferred Stock- The next form of equity in a company is preferred stock. Preferred stock can come in many forms, but it usually has greater rights and preferences than common stock, but is issued in the same fashion as common. In a liquidation of the company (say for a bankruptcy), preferred stockholders get paid back before common stockholders if there is anything left to distribute to stockholders. There are also many other preferences, rights, and privileges that can apply to preferred stock and in some cases, the preferred stock can be converted into common stock. These rights and preferences are usually added into amended articles of incorporation of the corporation that state these specific rights. You often hear of Series A, Series B funding, those are typically going to be rounds of funding with preferred stock, i.e. Series A preferred stock first, then Series B, then Series C and so on. The rights and preferences are too lengthy to discuss here as that is when the lawyers get involved, but things like conversion, anti-dilution, voting rights, board seats, and liquidation preferences are common.

Options & Warrants (not equity)- I put warrants and options in this section as they are commonly associated with or attached to funding, but they are not technically equity. An option or warrant is a contractual right to purchase stock in the future. It is ruled by the grant, which is typically in the form of a written agreement with the company to issue stock upon the occurrence of some future event. Examples of this are when the company goes public, gets more funding, or the holder of the option to purchase exercises that right and purchases the actual stock with cash.

I also bring this up in equity as options and warrants are technically “securities” which are covered by various securities laws, so some people don’t realize the implications of option grants or exercises. They also affect the ownership percentages in the company. The company’s accounting department is supposed to reserve stock for these future rights so that the company has enough stock to cover the options if they are exercised. This is when you hear about the “fully diluted” amount of stock in a company, it typically includes things like stock that would be issued in the future if the person exercises the option.

Below is a graph that shows forms of funding/liquidation preferences with warrants/options being low on the scale of rights held by an investor, but more flexibility for the company. The closer you get on the scale to straight debt (a loan), the more protected the investor usually is, but the company has less flexibility.



In the next section, we will look at the common types of funding drawing upon this basic knowledge of equity.

<u>II) Forms & Sources of Funding</u>

There are many forms of funding and sources. This gives a basic description of the most common forms of funding a startup company and where the funding comes from. This is only a basic brief discussion to give beginners an understanding so they understand some basic terms.

A) Debt Finance

The somewhat more common form in the last few years has been different types of debt financing, which is to say, a loan to the company. This can be created in many ways, as simple as an individual investor agreeing to give the company some cash and the company signing a one page promissory note. The more complex types involve significant legal documents like security agreements, credit facility agreement, security purchase agreement, and others. There a variety of terms that could be incorporated into a debt deal on when the money comes in, what it is to be used for, when payment is due, rate of interest, and other common loan terms that you may be familiar with from a mortgage or other loan you have had in the past.

The loan agreement is essentially a security in most cases, so there are securities laws and other considerations to execute this type of agreement properly. One of the most important to the bank/investor is to secure any rights to collateral if the company is delinquent in payments. In many cases with startups, the bank will try to secure any rights to not only the company's assets, but may ask for personal guarantees. When the bank seeks this type of security, it is considered a "secured loan" versus an "unsecured loan" when there is no collateral.

Many founders get so blinded by their feelings that their startup is the best idea since sliced bread that they don't realize the ramifications of signing a personal guarantee. If the company fails, the bank will take actions to enforce its rights against the founder who signed the personal guarantee. I have had many people, especially due to recent economic conditions, come to me in the last few years needing to file personal bankruptcy just to get out of these personal guarantees when their company failed. The bank may require a personal guarantee, so the founder is stuck either accepting those ramifications or having no working capital.

Common types of debt finance: credit line, bridge loan, straight promissory note, convertible note, credit card debt

B) Equity Finance

Equity financing is when the company sells equity (ownership interests) to an investor. See Part I discussion of the types of equity to understand the forms of equity that could be sold. The most common is selling a certain number of shares of common stock in the company representing a certain percentage of the company ownership. This is most often determined by using a valuation of what the company is worth before the funding (pre-money valuation) and after (post-money valuation). If it is a more sophisticated investor, group, or, especially with venture capital firms, the use of various rounds of preferred stock, e.g. Series A preferred, Series B preferred, etc.

These transactions involve documents such as subscription agreements, stock purchase agreements, investor representation letters, and other "closing" documents. Again, this also involves a security, often common stock being offered and sold, so the transaction and process must comply with state and federal securities laws.

C) Hybrid Finance

I use the term hybrid finance to categorize the different types that aren't traditional debt or equity finance. This can include things like convertible notes, where the company is loaned money, but the lender has certain rights to convert their debt into equity in the company. Usually the lender holds the right to determine when to convert, but sometimes it converts automatically upon the occurrence of a certain event. For example, say the company is loaned $50,000 and the terms may state that upon the company going public, the $50,000 loan turns into x number of shares of stock in the company.

Some other hybrids include convertible equity finance, such as convertible preferred stock (can be converted into common stock), combinations of debt and equity (loan and stock given to investor), and attaching warrants or options to a debt or equity financing (investor gets the contractual right to purchase stock at a set or pre-determined price). Someone could also invest money into the company in exchange for discounted options to purchase stock, although I haven't seen that by itself in the past as it doesn't give the investor much protection or rights.

There are also gifts, cash contributed by founders, personal credit cards or cash advances by founders, and grants that can sometimes be used for working capital in the beginning which may not be the traditional forms of finance.

All kinds of factors come into play when determining funding options for both the company and the investor such as tax consequences, security/collateral, liquidation preferences, stage of development of the business, and potential exit plan. Here is a graph showing various forms of funding and, in some but not all cases, their attractiveness/risks for the company and investor.

D) Sources of Financing

So where do you go to get financing? There are too many potential sources to cover them all in detail, but here are the more common:

Most common sources for debt financing are small/regional or specialized banks, small investor groups, small institutions, friends and family, and, one of the more common, the Small Business Administration (SBA). SBA loans are actually done through a bank that participates in the SBA program and the government provided a guarantee so that if the company fails, the bank gets back a certain percentage of their loan from the government.

Other sources of debt and equity can be categorized as: 1) angel investors- typically high net worth individuals who look for alternatives or diversification to traditional large company public stock, mutual funds, CDs, and other investments, 2) venture capital- firms that specialize in funding and growing startup and emerging growth companies, 3) friends and family- this is pretty obvious, get your friends or family to give you the money, and 4) institutions- which I classify and include certain divisions of bank, private equity firms, and hedge funds.

In order to pursue these sources, you need to have your idea well developed and thought through, usually best in a business plan. It is also good to put together a 30 second elevator pitch of your business, 5 minute presentation, written executive summary, and the dreaded full business plan with financial projections and other related exhibits. Founders often don't realize that this process involves offering a security in the process (whether in the form of a loan or sale of stock/options) and securities laws are involved. I will go over private placement memorandums and some of the more common legal and securities pitfalls to avoid during this process next.

III) Private Placement Memorandum

So what exactly is a private placement memorandum (PPM) and why do I need one?

What is a PPM?

A private placement memorandum is an offering document, sometimes called a prospectus, offering circular, or PPM. The majority of early startups and emerging growth companies commonly raise money through what are known as private placements. It is simply a sale of stock (or debt) in the company to private investors that become shareholders in the company. The reason they are classified as private, is not because they are private investors, but because the offer and sale of stock (a security) does not involve any public advertising or general solicitation of investors. For example, when a stock goes public, they are offering stock publicly by filing a registration statement, press releases, etc. This process of registering the securities with the SEC allows the company to utilize the media and other methods to offer its stock for sale. Since most companies don’t have the money or resources to file a registration statement with the SEC, they rely upon selling the stock through exemptions from registration.

Although there are other exemptions that are used, the most common exemptions used under federal securities laws (Securities Act Section 3(b)) for startups raising money are:

Regulation D- Private offer and sale of securities requiring compliance with manner of offering requirements and limitations on resale of securities requirements. The common categories are listed under the following 3 classes:

Rule 504- raise up to $1 million within 12 month period; no specific information requirements for PPM

Rule 505- raise up to $5 million in a 12 month period; unlimited number of accredited investors and only up to 35 unaccredited investors; 502(b) information disclosures required

Rule 506- unlimited amount of money raised within a 12 month period to accredited investors; unlimited number of accredited investors and up to 35 unaccredited, but “sophisticated” investors; Rule 502(b) information disclosures required

If Rule 505 or 506 placements are only sold to accredited investors, there is no information specifically required to be provided. If there is even one non-accredited investor, the company must provide (unless they are already a reporting company with the SEC) certain financial and non-financial statement information.

Section 4(5)- up to $5 million; unlimited number of only accredited investors

The term accredited investor was amended recently under the Dodd-Frank Act. There are a number of categories to qualify based upon things such as recent income and net worth, but the main change was to limit the definition for net worth to not include the investor's primary residence as an asset and not include the mortgage on their primary residence as a liability (except for debts taken out within 60 days, for example a cash out refinance).

Rule 502(b) does also required the company to provide reasonable access to information requested by potential purchasers for Rule 505 and 506 offerings prior to their purchase.

Even though a sale may be exempt from registration and have limited or no information requirements to provide to potential investors, the anti-fraud rules still apply and a company can get into a serious bind if they misrepresent, lie, omit, or misstate items about the company, its business, its management, future business, and other items.

Also, as of this e-book publishing, we are still waiting for further rule-making changes from the SEC for loosening or eliminating the public advertising and general solicitation rules in some cases. This could end up being a help to small companies to give them better access to capital, but we will know more once those rules are finalized. See my website section on Dodd-Frank and other relevant legislation for more info on implementation and new laws.

Those exemptions require that no public advertising or general solicitation is used in the offer and sale of those securities. So, the company is not able to start issuing press releases, posting website ads, or sending mass mailings to potential investors in most cases. This does make it more difficult to get your message out there, but it must be complied with for the offering and sale to qualify for the exemption and not violate securities laws. Often this results in needing to be introduced to prospective investors through connections.

When the company decides to raise money through a private placement (which can also be in the form of a loan, which is still classified as a security), they have certain rules they must follow for the placement to qualify for the exemption and comply with securities laws. Typically, the company was already in the process of, and I highly recommend, putting together things like a 30 second elevator pitch of their company/product/service, a 5 minute presentation, a written executive summary, and a full business plan with financial projections, pro forma data, exhibits, and other relevant materials. The full business plan is essentially the formal document given to potential investors to tell them about the business, its product or services, management, financial projections, and plans for the future.

A recommended list of categories for your business plan (which will also cover many of the PPM information requirements):

- **Executive Summary-** A brief, usually one page or so, overview of what your company does, how it is different or solves an existing problem, who your team is, and what your plans are to grow the business (i.e. how are you going to make money for the investor)

- **Management Team-** Name, title, and a bio on each top member of the management team (officers and directors) to show what experience or assets they are bringing to the table

- **Product or Service Description-** What do you do and how is it novel or better than something else out there and how do you make money from it?

- **Intellectual Property Protection-** How have you or will you protect your company's ideas, brand name, developments?

- **Manufacturing and Operations-** How will you produce the product or provide the service, as well as manage and operate the administrative side of things?

- **Human Resources-** How many people do you have now and how many do you plan to bring on? Any other challenges, such as using independent contractors versus employees? Do you still need to identify and hire certain positions in the company?

- **The Market-** What market are you targeting and where do you fit into it? What is the landscape and current trends in the market or industry?

- **Competition-** You are probably not the first person to think of this, so how are you better or different than your current or future competitors?

- **Sales and Marketing-** How do you plan to get your message out about your produce or service?

- **Company Background and Structure-** things like current capitalization, how the company was formed, is it a C corporation formed in a certain state…

- **Financial Information-** current, historical, and future pro forma financial statements such as balance sheet, statement of cash flows, and profit and loss statement.

- **Exhibits & Footnotes-** At the end when you may want to attach full pro forma financial statements as exhibits, you should also think about other things related to the business. Some people add a copy of the patent filings and issued patents the company owns, research/white papers, SEC filings, license or joint venture agreements, process flow diagrams, and other information that you can summarize in the body of the business plan, but provides more detailed info if the investor wants to read more. In place of these sometimes lengthy documents, you may want to add footnotes in the body with hyperlinks to the source for your information for the investor to read through those links. Of course, you want to think about confidentiality when it comes to any documents provided, but showing your sources for information can help to show that you have done your homework.

It becomes essential for the company and management during this process to cover all bases and be sure it is protected from lawsuits and SEC or other regulatory action. When a company fails to execute what they said they would do and the investor loses their investment, the plaintiff's lawyers start circling looking for someone to go after, like the board of directors and upper management or just about anyone involved with the investment process. This is where a private placement memorandum can be a valuable tool to help protect the company and its officers, directors, and others.

How does a PPM help?

No one can guarantee that the SEC, state regulators, or private investors won't pursue claims against the company or management, but there are steps you can take to limit any potential exposure. This is where the PPM comes in. The PPM is an offering document that is an expanded form of the business plan that is given to investors. The basis for PPMs go back to the information often required in a full registration statement filed with the SEC. Depending upon the exemption used for the number and level of investors, time for funding, and amount of money raised, there can be differing requirements for what must be provided in the PPM. Even if the exemption doesn't require some element to be disclosed to investors, it is often a best practice to simply cover all your bases in that document. That is not to say that there may not be a legitimate business reason for not disclosing something when you are not required to do so. For example, in some cases you need to provide a recent audited balance sheet. Many startups don't have the money to pay auditors to come in and audit their books to obtain the balance sheet, so if there is no requirement to provide that audited balance sheet, it may be best for the company to avoid that additional expense.

The basic principle behind the PPM is to fully inform the investor about all aspects of the business, company, industry, management, prior financial performance, and future prospects, as well as providing certain risk factors involved with investing in a new company, often with no revenue to sustain it. The SEC and state regulators want to be sure that you disclose what is required and don't over-hype your company. The biggest threat is the anti-fraud statutes. If you put something in the PPM that is materially misstating the facts, misleading, fail to include relevant facts, or an outright lie, you can end up facing serious civil and criminal penalties. As an officer or director, you have certain duties and you have to be sure that you have control over what is happening in the fund raising process. Just as was discussed in the section on Finder's Fees, you don't want a random finder running around selling your stock by saying whatever they need to make the sale and try to get a commission.

How do I get a PPM?

There are services online and companies that offer templates for PPMs, but be cautious in going down that path just because it looks a lot cheaper. If you fail to disclose something you should have and lose your exemption from registration, you could end up in a situation where the invested money is gone, but a regulator is telling you to offer to buy back the stock you sold the investor. Guess who can end up holding the bag if the company is out of business at that point? You.

It is always best to hire a local licensed attorney to assist you in this process. Look for someone with experience in securities laws and private placements. You can save time and money by putting together a good business plan internally, but then having the lawyer add, edit, or clarify the business plan to make it into a full and compliant PPM.

What needs to be in the PPM?

This depends upon the exemption being used for the current offering, but it is best to try to include some general discussion in categories such as: summary information and risk factors, offering terms (e.g. offering for sale of 1,000 shares of common stock at $1 per share), use of proceeds, dilution, plan of distribution, description of securities to be offered, and certain information about the company and its business. This is really a matter for your lawyer to review to be sure you have adequate disclosures. Also, they should review the PPM to be sure that anything that you say in there may not be construed by an investor as misleading or fail to include something material to the business. You want to be sure the document is clear and easily understandable.

Many startups worry about weighing the document down with all that "legal mumbo-jumbo," but if you are dealing with any investor who has been through the process with a legitimate company, they are familiar with those disclosures. You can see examples of how much risk disclosures are involved by finding a copy of a prospectus for any large publicly traded company. They go on for pages and pages and cover all kinds of random disclosures of possible risks down the road, but they are being cautious to warn investors. The SEC wants to know that investors are being informed and not misled. Most PPMs will include a statement about risks of "forward-looking statements" for things like projected revenues, which is normally a safe harbor from enforcement for public companies, but it is a best practice to include it anyway.

What else needs to be done in the process?

There are other things that are a best practice to in connection with a private placement. You should setup a control log where you document to whom the PPM was given and when. You normally should set definite dates to close the round of funding, be sure to file any required federal or state disclosures, such as a Form D with the SEC or a Form 25102 in California, keep track of when and how much was raised for calculations of exemptions for future rounds, and complete closing checklists. You need to be sure that all your investors got the same version of your PPM, even if they got a shorter business plan. These are all things that companies don't realize can affect their ability to do business down the road, so it is always best to have a licensed, local attorney assist them with the entire process.

IV) Finder's Fees

So you have a great idea, founded a company, and you are telling your friends and family about it. It is difficult to succeed without some working capital, i.e. cash in the bank. If you are new to startups or haven't had to worry about raising money before, you suddenly are introduced to a new world of people who claim they have very rich friends or "know people." They would love to help you raise some money, but they want a piece of the action. They may ask you for a percentage of the cash their "people" bring in, a percentage of equity in your company, a job with your company, or maybe some combination of these. So what can you do to compensate someone who claims to be able to bring you in anywhere from a few thousand to many millions of dollars in funding?

This is a very common problem that founders and early startup companies face. **Here are some common questions:**

- What the "norm" is for these types of deals? None, if done, they vary widely on circumstance.
- What percentage of equity should I give them? Probably not a big deal what you give as long as you still retain control of the company and are allowed to dilute them down in the future
- Should I use options instead? Possibly.
- Should I just give them cash? Probably not.
- Am I wasting my time with this person or can they really can bring in the dough? Probably.
- Should they sign some kind of non-disclosure agreement (NDA) or other legal document? Probably, yes.
- Are there any risks to me or the company if I go with this person? Yes, even if they are licensed or registered to be a broker/dealer.

- Can I pay my employees or bring the finder on as a VP to pay them a finder's fee? No, that doesn't really change the analysis of whether it is legal if it is a percentage of the raise.

I will discuss the legal issues associated with finder's fees and the bottom line, starving company CEO point of view, as well.

A) Legal Issues with Finder's Fees

Broker-dealer Issues

The core issue comes down to the fact that you may not think about it, but you are trying to sell a security. You or the finder will be offering and selling stock or some form of ownership in your company. A "security" is defined by the Securities Act as any note, stock, treasury stock, bond, debenture, evidence of indebtedness, and numerous other transactions. So, even if you do a debt finance deal, that is still the sale of a security, i.e. the promissory note or other evidence of indebtedness. Anyone who receives a commission or compensation from that transaction is normally considered a broker-dealer in those securities since they are making their money from trying to sell the security. There are state and federal regulations on broker-dealers, the most relevant of which is that they must be licensed/registered with the appropriate regulatory agency. The SEC and states have their own registration or licensing regulations and procedure.

When you think of your big bank brokerage account and think about the investment advisors and similar roles within them, that is normally a licensed broker-dealer. Just because it is you or a finder out trying to raise money for your small startup company and not selling shares of Microsoft, that doesn't mean that broker-dealer regulations aren't still in play. As the issuer (company selling the securities) and its personnel (CEO, CFO, etc.), you are probably not in the business of buying and selling securities and do not need to be registered or licensed to raise money just for your business; however, the finder often is under those obligations.

There are some limited exemptions provided so that an un-registered person may still engage in the buying or selling of securities. They are too technical to go into detail, but there are exemptions for certain intrastate transactions, for personnel of the company in offering their own securities for sale (although they **cannot be compensated** with a commission based upon those transactions to fall within this exemption), and some others. The law is very specific about the requirements for insiders to use these exemptions. For example, you cannot simply hire a finder as an employee or officer of your company, have them raise money, and then let them move on. They can't be paid a commission on the transaction amount, even if they work for you, must perform substantial duties for the company outside of raising money, and can only use this exemption generally once every 12 months.

There are also disclosure requirements and other things that a licensed broker/dealer must comply with to comply with the law. A finder would technically be subject to those if they are required to be registered. As the issuer, you can face liability for fraud through misrepresentations, omissions, or blatant lies made by the finder or anyone else you send out there to raise money.

Legal Risks in Signing with a Finder

Assuming the finder is not licensed or registered with the appropriate agencies and does not fall under an exemption from registration, the finder can be held liable to the person who purchased the security (the investor) for the amount paid, as well as possibly subject to civil penalties to the regulatory agency and possibly face criminal liability. These actions can be taken by the state or federal agency in charge of regulation, or possibly both. Although I am not an expert on the civil or criminal ramifications for issuers (company) and its management, I can see potential aiding and abetting the crime of selling securities without a license. Also, the issuer and management can be held liable for recklessly made hype about the company, its prospects, financial condition, and a variety of other items. This could come in the form of shareholder lawsuits, SEC or related agency civil or criminal prosecution. For example, in California, under Corporations Code Section 25501.5, the investor has the right to rescind (cancel) the investment and seek damages against the unlicensed person (finder). Generally, that would mean the finder has to give them their money back that they invested and could face additional damages. However, this section does not directly impose liability on the company, but that doesn't mean a plaintiff's lawyer won't try to sue the company and its management.

The majority of the risk falls on the actual finder and many self proclaimed "finders" are not even aware of the fact that they are doing something that may require registration or licensing as a broker-dealer. However, a loose cannon out promoting your company and making all kinds of promises about how good of an investment it is or anything along those lines can take the company and its management down into potentially major risks for the company and the persons involved.

B) Bottom Line Starving CEO View

I have worked in the trenches and can tell you that when your company needs cash to survive and grow, you tend to forget about the legal ramifications and just want to get to that right person who is going to get you the cash. I am not telling you to forgo the law and do whatever you want, but knowing the risks, each startup exec needs to make the decisions to move forward or not. I have worked within companies where it paid out equity and cash and signed many finder's fee agreements usually anywhere from 1% to 10% typically, sometimes more. It was paid in cash, equity, options, or a combination. In some cases, the finder's fee was even disclosed in public filings with the SEC and audited financials/footnotes. The SEC, SIPC, or any other regulatory agency did not come and knock our door down and take everyone away in handcuffs. That isn't to say that you couldn't be arrested and charged by the SEC with some form of fraud or other crime if your finder was out there over-hyping your company. There are risks associated with these deals, but usually that would come in the form of lawsuits by unhappy shareholders who invested through these finders.

<u>Some quick pointers if you do decide to take on a finder's fee arrangement</u>:

- **If the person or organization is one that normally raises money for companies (e.g. investment banker), they are probably or should be licensed broker-dealers and can receive a commission, success fee, or other arrangement, so go with those first if they are currently licensed and put it in writing.** This is not to say you should just blindly sign on with them. There are still risks if the person doesn't comply with any disclosure requirements or makes fraudulent or misleading claims about the company or its future, so be sure you have checked them out and they are reputable.
- **Don't accept everything they say as accurate**. Many finder types are natural salespeople and can be a good asset to talk up your company, but they are notorious for what many call "puffery" or exaggerating the facts to make something sound better than it is. Whether licensed or not, a broker-dealer or finder can be liable, as well as the company and potentially management, for

material misstatements, omissions, misrepresentations, and outright lies by this finder. Think of the examples from the media about "boiler room" operations and avoid those like the plague.

- **Do try to protect your company by putting something in writing.** At the very least, get a good non-disclosure agreement in place with non-compete, non-circumvention language to the extent that it is enforceable in whatever state or place where you are raising money. You can at least try to let them know you are not going to let them try to steal your ideas, plans, or other intellectual property

There are ways to draft finder's fee agreements to, at least in writing, limit the extent of what the person can and can't do or say when out there trying to bring in investment dollars. This way if things go bad, you can at least have something you can point to in court to show that you made it clear that they could only do and say certain things. These won't stop the SEC from pursuing fraud, criminal or civil claims against you or your company, but it is a way of trying to limit exposure. I always advise clients of the potential major risks for the company, management, and the finder before pursuing any form of finder's fee agreement.

- **Be clear to limit what the person can and can't do and make it a non-exclusive relationship**. Don't promise them some future board seat or CEO role, limit it to the transaction at hand. Be clear that they are there to provide introductions only to people that may be a potential investor. The least risk is to only get the name and contact info for the potential investor and then have management deal with follow up. Be sure the finder is not out doing road shows or hyping your company on their own. Have them provide their investor contacts in writing and when they were referred to the company. Also, don't agree to an "exclusive" finder or similar arrangements if you can. An exclusive finder is one who can be a real pain if you bring in money from elsewhere and there is a fight over where the money came from. When you stick with non-exclusive, it puts the burden on them to be sure they document that it was their contact and could avoid litigation.
- **Assume the person will not come through.** Unless you have some connection, relationship, or prior experience with this person that has proven their worth, don't rest your company's future on one person who is probably working on 100 other companies through finder's fee

agreements. They are out for their bottom line, just as you should be with your company. Keep working on other ways to raise the money yourself.

- **Don't worry so much about some exact percentage of cash or equity to be agreed upon**. Do agree on something from the start so that everyone knows going in. The capitalization of the company is going to change so many times in the company's evolution that 10% of equity now will probably be 0.001% later.

In the end, it is up to each company and their executives or board to make these kinds of decisions based upon risk versus reward. You also need to think about it this way, if this person is so well connected and believes in your company so much, ask them to put their own money into the company. I know a lot of people in the finance and legal world will tell you just not to do this in any event, but I am aware of the challenges of being management in a company that needs those funds to grow, so I will tell you that the best option is to avoid these relationships, but if you do enter into them, try to limit your potential downside risk and seek out some legal guidance in moving forward.

There are discussions these days of a so-called **"intermediary"** who is essentially a finder. New legislation is looking to allow intermediaries in certain fund raising in connection with crowdfunding; however, those laws have not yet passed, so the specifics of using an intermediary are not finalized and they still should be treated the same as discussed above for finders.

V) Capitalization, Cap Table, & Initial Accounting

I) Capitalization

People need to have a basic understanding of what capitalization of a company means before they can really understand what a cap table is. Capitalization is a term that deals with the capital structure of the company. It is made up of the amounts and types of financing used by a company. Types of financing include common stock (which can include founder's stock), preferred stock, retained earnings, and debt. It provides a general overview of the company's debt and equity. You add the long term debt, equity, and retained earnings together for the normal total number. Most people are familiar with a version of this called market capitalization or market cap. That is essentially taking the number of issued shares of common stock times the company's current price per share for a total number of market cap. It is one number used to determine an estimated value of the company as a whole. It can also change due to accounting changes due to various transactions.

II) Cap Tables

A cap table is basically a summary of the company's capitalization and ownership. There are various forms of cap tables used and there is no one template that is the agreed upon version of a cap table. Although they can give a summary overview, the detailed version needs to be put together from the start of a business which includes specific details about who owns what from day one. It could include things like a historical timeline of stock issuance with the date of issuance, name of shareholder, number of shares, consideration given in exchange for the shares, and some accounting entries related to that consideration (cash, services, etc.). It could also be less detailed with a general overview of the total number of shares of stock issued and amounts still available for issuance. You want to keep the detailed version with actual shareholder's names internal and only use a summary grouping such as "founders", "seed investors", "Series A Preferred", "Series B Preferred", "employee options", and so on.

Some other common terms used in connection with a cap table are pre-money valuation, post-money valuations, price per share, dilution, options, warrants, percentage of ownership, and preferred stock. It is usually easiest to create a cap table through Excel or an accounting program, such as Quickbooks. You can purchase and download templates online; however, they are not all that complicated to put together on your own if you understand the basics of capital structure and a little accounting and finance.

A very simple example of a cap table would be:

Type	Value	Price per Share	Shares	Total Ownership
Founders -	$5,000	$1.00	5,000	50%
Investors-	$5,000	$1.00	5,000	50%
Total-	$10,000		10,000	100%

You will normally want to include variations in your cap table that show what happens if more shares are issued, such as upon someone exercising their option or warrant right to purchase stock or additional funding rounds. It should show clear calculations of valuation and percentages of ownership both pre-money, post-money, and fully diluted post-money (if you assume that any options are exercised, warrants are exercised, or a convertible note is converted and result in stock issuances). An investor wants to see exactly what they will own in all possible scenarios.

III) Initial Accounting Practices

I will discuss the initial accounting that goes along with capitalization to expand upon the cap table preparation. I will keep it pretty simple and use an example of a California corporation.

When you first form the corporation, you list in the articles of incorporation filed with the secretary of state the total number and type of shares that are "authorized" to be issued. Think of those like a total pool of available stock in the company's bank to issue when needed. For purposes of this example, let's say the company authorizes 1,000,000 shares of common stock and 1,000,000 shares of preferred stock. Although these days you often don't have to list what they call a "par value" for the authorized stock, but it is easiest just to pick something like $0.001 as a par value for accounting purposes. The initial issuance to founders of 500,000 shares of the 1,000,000 pool of authorized stock is in exchange for them putting in $50,000 of their own money into the company would have an accounting entry like this:

Account Name	Debit	Credit
Cash	50,000	
Additional Paid In Capital (APIC)		49,500
Founder's stock (500,000 shares x $0.001 par value)		500

Each side (both debit and credit) total 50,000 so the accounting entry reconciles and is in balance. Both APIC and founder's stock go towards the overall equity and capital of the company, so the balance sheet would show assets of $50,000 in cash and owner's equity of $50,000 total with no liabilities. There would still be 1,000,000 shares authorized and 500,000 shares issued as the capitalization structure. The founders would own 100% of the company as you only look to what they own out of the total amount issued of 500,000, not the amount authorized since those have not yet been issued. When the remainder are issued out of that pool, the founders would get diluted down from 100% ownership to as low as 50% if the rest of the authorized are issued to new investors. This would result in a price per share of $0.10 per share ($50,000 investment divided by 500,000 shares).

Many founders try to figure out how to account for the founders stock issuance if they didn't put much cash into the company and got a large number of shares (e.g. 1,000,000 shares issued in exchange for $500 initial investment = $0.0005 per share price). There can be tax and accounting implications, but you shouldn't be that concerned about that low of a share price since it is really more of an accounting entry and not a real determination of value of the company. If the company is that concerned about how that may look, they can make the initial issuance at a higher share price (and bring up the valuation) if there is a legitimate basis or valuation model to support it. One thing that would stick out is if you started the company with a $500 valuation based upon $500 cash being contributed and the next day the company is trying to raise $500,000 for 50% of the company based upon a valuation of $1,000,000. You would need to justify where the value is coming from (e.g. future revenues, contract deal, patent acquisition). Valuations in early stage companies can vary widely and are extremely difficult to accurately forecast anyway, so don't get too caught up on a low per share price.

When it comes to initial capitalization, the founders typically do need to show that they contributed something in exchange for their shares. California Corporations Code Section 409(a) allows the board of directors to issue shares for:

1) Cash, 2) Labor or services already performed for the company (e.g. formation, fund raising, business planning), 3) Cancellation of debt, or 4) Property given by that founder to the company (e.g. assigning a patent the founder owns to the company). You cannot, however, issue shares for future services or a promissory note, in most cases.

In many cases, you don't need to worry about including things like par value on a cap table, but the total values involved with the stock issuances should be. Often you will see the more detailed accounting entries if you look at a public company's financials in the statement of stockholders or owners equity. That is really a variation of a cap table and might be able to give you some further examples although it may not show dilution for options or valuations.

VI) Executive & Employee Hiring, Compensation & Related Issues

An overview of some of the common questions from both founders and newly recruited early-on employees about what is the proper way to be compensated.

A) Hiring Process

Recruiting, Applications, & Interviews:

The main concern during the hiring process is to avoid claims for discrimination or possibly breach of contract or wrongful termination if the person is hired and something said or promised during hiring does not occur. For example, if you keep telling the person that they will be promoted to CTO within 3 months and you plan to keep them with the company for at least 2 years and you then terminate them after 5 months without promoting them to CTO, you may face a claim that there was an implied employment contract and you breached the agreement by wrongfully terminating it.

You need to take all precautions to avoid actual or perceived discrimination in hiring. Discrimination can occur when a protected class of people are discriminated against by things like not hiring due to their gender, race, or religion. There are also claims for discrimination for things like a pattern of hiring only one race and no others, or when comparing 10 equally qualified applicants and only a certain religion of people is hired. Protected classes depend upon various state and federal laws, but generally, protected classes can include: gender, marital status, sexual orientation, religion, disability, age, and race. This means that you should not include any kind of preference limitations in any advertising for the job or during the hiring process unless it is a bona fide occupational employment qualification. Also, any hiring standards must have a legally justifiable basis and meet a business-necessity test. If the hiring standard meets the business necessity test, it could be used to avoid a claim of discrimination in hiring, even if the person is in a protected class.

When interviewing candidates, you need to be cautious in what you say or imply so that it does not also show any kind of preference or discrimination against a protected class. In addition, you need to avoid any false or misleading statements about what will happen in the future, try to get them to move to the area based upon lies about the employment, or generally any statement that could be construed to be a promise that you never or don't intend to fulfill.

One other specific caution for tech companies these days would be recruiting a candidate away from a competitor. California is generally pretty liberal in allowing employees the right to change employers whenever they feel like it, unless there is a valid employment agreement that says otherwise. If you recruit a competitor's developer in order to gain access and use their knowledge of the inner workings of the competitor, that could be viewed as trade secret misappropriation. Also, if you try to persuade a competitor's employee to leave and work for you and you know that would break their employment agreement, your company could face liability for inducing a breach of contract.

In general, you cannot use hiring standards or qualifications such as: age, national origin, US citizenship, lawful alien, or refugee status. You cannot refuse to hire someone simply because they have a bankruptcy, are in a alcohol or drug rehab program, or were in a rehab program. You can refuse to hire based upon current drug or alcohol use, impose dress and personal appearance standards, or place a requirement to speak English if job related.

When questioning the applicant during the interview process, you can ask whether they are eligible to work in the US, but most questions about age, marital status, mental or physical disability, pregnancy, or religion. When it comes to crimes, you can ask about criminal convictions, felony convictions, criminal charges or arrests that are still pending. You can't ask about marijuana-related offenses more than 2 years old, arrests without a conviction, or participation in a drug or alcohol diversion program.

References or Background Checks

When many companies look into an applicant, they want to know as much about their other recent job performance as possible. In most cases, the employer is allowed to ask various questions related to the applicant's prior job performance, with or without express permission to contact references. Most of the time, it is tough to get much information because former employers are aware that if they give negative information and the person isn't hired, the former employee could try to claim defamation that resulted in them not getting the job. Most employers have policies where they will only confirm that the person worked there and their dates of employment.

If the company wants to run a credit check, they need to comply with various fair credit reporting requirements. If they want to run a background check, they also need to comply with certain laws and notice requirements, so properly prepared notice in writing given to the employee need to be used.

B) "Independent Contractor" versus "Employee"

One major issue faced by business, small or large, is the battle with whether someone is an employee or an independent contractor. This can have various major and minor implications on the company and the hired individual. Many people think that they can just call someone an independent contractor or a "1099" and that assures they are not an employee. That is not the case and there are specific tests used to determine someone really is an employee.

If the employer hires someone as a 1099 and pays them without taking out tax withholdings, but they turn out to qualify as an employee, they can face serious monetary and other problems down the road. In addition to tax issues, they also might suddenly be subject to laws covering things like minimum wage, required rest periods during a workday, workers compensation requirements, and overtime pay.

In California, the Employment Development Department (EDD) and IRS generally set out the tests for determining if someone is independent or an employee. Generally, they look at the following items:

- Who controls or directs the person on how to perform the work?
- Does anyone provide training on how to perform the work?
- Does the contractor have their own established business and do they have their own tools or specific training? Can they perform the work anywhere or do they have to come into an office for set hours?
- Does the worker contract out with other employers or hold himself out to the market as able to work for others?

- Is there an opportunity to profit or lose from the relationship and are they paid on a per project basis or hourly/salary?
- Does the company retain the right to terminate the person?

Companies need to resist the temptation to simply call someone a 1099 worker without examining the factors that can affect it down the road.

Even if you hire independent contractors and they are not considered employees, you should still put together an independent contractor agreement in writing that sets specific terms of what you are hiring them for, how they get paid, how long it should take, and confidentiality terms to clarify the relationship and avoid future disputes.

C) Employment Agreements, Confidentiality Agreements & Other Initial Documents

Initial Documents

There are a number of documents that the company needs to fill out or have on file to comply with state and federal laws. This is a best practices list that includes both required and non-required items:

- Employment offer letter (not required)
- Employment contract (not required)
- Employment application (not required)
- Job description (not required)
- Consent to background check or other requested testing (only need to obtain if you utilize that qualification)
- INS Form I-9 (required and you need to verify the documents listed such as passport, driver license, or social security card; it is also best to make a copy of each of these)
- IRS Form W-4 (required)
- Employee handbook with company policies and procedures, can include or separately have what is called an employee proprietary information and inventions agreement (covered below, essentially a confidentiality and non-disclosure IP protection)
- Insurance or other benefit paperwork (401k, stock option plan, payroll direct deposit)

Employment Agreements

California, like many other states, is a presumptive "at will" employment state. This means that employees you hire are presumed to be at will and either the employer or the employee can terminate employment at any time, generally for any reason, although there are some discriminatory practices that could get the company in hot water. Ways to change the relationship to more of an employment for a specific term or under certain conditions is to have a written employment agreement or, in some cases, an employment agreement can be inferred from actions and statements prior to and during the course of employment, so employers need to be cautious in making bold statements about someone's long term future with the company.

Most often when hiring the top management for the company or other key personnel, such as a top engineer or developer, many companies will use written employment agreements. The employment agreement can set a specific length of employment or it can also include a clause that employment is still "at-will" and can be terminated at any time. It can be useful to define the specifics of that person's employment and avoid litigation down the road because of ambiguity in some term of employment.

Some of the items that generally may be included in an employment agreement are:

- Specifically define who the two parties are to the agreement
- Length of employment or whether it is at-will
- Specific reasons that the employer or employee could terminate employment and what happens upon termination
- Place of employment where the work will be performed
- Specific Duties and Authority of the Employee (tries to limit what the employee may be able to say to bind the company as an agent of the company)
- Compensation- both cash, incentives, benefits, deferred compensation
- How business expenses are handled
- What happens to the employee if the company goes public, gets acquired, or some other major event (used mostly by top personnel to keep their job with the company or get some form of bonus to get the company to that level and walk away)
- Generic contract terms for dispute resolution, choice of law, etc.

- Confidentiality- covered next

<u>Employee Proprietary Information and Inventions Agreements (EPIIA)</u>

EPIIAs or sometimes referred to in other names like confidentiality agreement, non-disclosure, or otherwise, are used to protect both the company and the employee related to intellectual property. The point is to set in writing the following to avoid disputes:

- What are the employee's obligations to try to protect confidential information
- What information is confidential
- Define who owns what IP going into the employment relationship- For example, if you developed 3 apps and filed 10 patents on your own prior to employment, it would set out an explanation of those items and that they remain your property, not the company's
- Define what happens to inventions or developments made during the employment relationship
- Define what happens to the IP after the relationship terminates

A company needs to have similar confidentiality agreements to use for independent contractors, business service providers, and other hired businesses to be sure that they protect their intellectual property.

D) Forms of Compensation

<u>Cash- Salary or Hourly</u>

There are a variety of compensation forms that a company can use to pay its employees, such as cash in the form of hourly or a salary, stock grants or purchase rights, deferred compensation, stock options, and benefits. The concern when it comes to compensation in a new or small company is that you must comply with both state and federal law on issues such as minimum wage, overtime, and breaks. There are specific rules on paying at least minimum wage, even in many cases to interns. The rules also cover payment of an increased overtime wage if the person works more than 40 hours. The employee must also be provided with certain breaks and rest periods depending upon how much they work. There are certain exemptions from these wage and hour requirements for certain executive, administrative, or professionals at the company, IT workers, outside salespeople, and more.

Minimum wage & overtime issues

One problem when it comes to a startup is the possible violations of minimum wage or overtime when the person is only paid in stock, stock options, or a combination of both. The minimum wage and overtime laws generally will apply to require payment of cash for at least the minimum wage, even if they are getting lots of equity in the company. That is not to say that the company many not be able to avoid those requirements if the employee does qualify as exempt.

Other benefits- insurance, retirement

Other benefits such as sick time, vacation time, health insurance, retirement plans, and leaves of absence are generally up to the employer if they want to provide them, so most startups avoid these benefits due to the record keeping and administrative setup time involved, not to mention the costs. The company is required by law to provide time off for certain events, such as pregnancy, certain disability or medical leaves, voting, and serving as a juror or witness in court. In most cases, though, the company is not required to pay the employee while they are off, but they may be eligible for certain state or federal leave payments.

The new laws relating to health care are still in implementation, so issues related to what requirements the employer may have to provide health care can change depending upon factors like the size of the company.

In California, all employees are required to be provided workers compensation benefits. Also, the employer is responsible for things like their portion of any employer payroll tax and withholding, disability insurance requirements, or other similar public benefit programs.

Equity & Related Comp

Many people wonder how much of a startup they should get in stock or options. First answer is that the company doesn't have a duty to give you anything, much less a specific percentage. Now most people weigh the risks of a startup folding by how much equity or options they get in sweat equity. It is really up to the company through the board of directors or through a equity or option incentive plan. If the board authorizes the plan or the grant, it is generally okay. The company needs to realize that they have to recognize compensation expense on their books for equity and option grants, not just cash paid out. Most of the time for startups, it doesn't really matter since they are in the red anyway. It is always best to come up with company-wide policies, even in a small startup. These can give guidelines for how much in grants can be given out and what factors go into making those decisions. The policies can be put together with a formal written plan of incentives that the board can authorize management to offer to new employees or existing employees essentially as bonuses for good work. One major issue is that existing, or sometimes future, investors will want to know how much dilution they will face when option or equity grants come down. Also, management needs to report to the board and then to shareholders ultimately in terms of the reasonableness of grants. The other thing that helps with a more formal policy is that it can help avoid the rumor-mill going around that someone got more equity than another. The other item for the company to recognize is compliance with SEC Rule 701 discussed below.

Rule 701- When it comes to stock or stock option incentives, SEC Rule 701 deals with equity compensation to employees to non-reporting companies, i.e. private companies small or large. Those benefits are technically sales of securities since you are giving stock or a stock option (both securities) in exchange for services rendered versus actual cash for them. Rule 701 provides an exemption from having to register those securities issued under an equity incentive plan as long as they fall within certain limits in a 12 month period. The company does need to provide the employee or consultant with a copy of the written benefits/incentive plan or other contract within which the stock or option is being granted. The benefit is normally to be provided to an employee, but there are provisions to allow the exemption of Rule 701 to apply to certain independent consultants who are similar to employees.

Deferred compensation-

This is a potentially huge area in dealing with issues such as taxes. Many incentives or benefits can be classified as deferred compensation, even if someone doesn't think that they would. For a startup with little money, accruing (keeping accounting records to document and add up) and deferring compensation is often a necessary tool to get early employees paid for their time before the company has the cash to pay them. They do take a risk in accepting deferred compensation since the company may never be in a position to pay it. That is not to say that you can found a company and starting accruing as CEO a $400,000 salary because most investors are not wanting a large part of their money going towards your prior salary, especially if you have substantial equity or option rights.

The biggest issue for deferred compensation, usually in the context of deferred salary or other benefits for executives, is the tax treatment for the individual under IRS Code Sections 409A and 83. If the deferred compensation is fully earned and not at substantial risk of forfeiture, it is treated as current income for the employee/executive when earned, not when paid to the employee. Section 409A allows for an exemption from that current income tax treatment. There are certain rules for electing deferred compensation and treatment depending upon whether the deferred compensation is qualified or non-qualified. The whole process involves examining several issues beyond just 409A, such as the constructive receipt doctrine, the economic benefit doctrine, and IRS Code Section 83. This topic is too complex to discuss in detail in this article, but needs to be addressed or at least considered when it comes to compensation issues, especially since stock grants to employees or founders can be considered deferred compensation. If the benefit plan is structured properly, you can avoid those immediate income tax issues for the employee or executive. Also, an 83(b) election often needs to be made with the IRS quickly, even for founders to potentially avoid negative tax consequences from immediately recognized income.

Resources for Recruiting Founder, Co-founder, and Technical Talent:

When looking to recruit top talent, of course, the usual suspects are good to search through like Craigslist, Twitter, Facebook, and LinkedIn, especially within some of the groups. I will list some of the other startup related recruiting websites, but the best source for good talent is through people.   When attending networking conferences, events, and joining various groups, look for ways to get the message out that you are looking to join forces or bring someone on.   If you get VC or angel money, they can be potential sources for where to look, as well as attorneys, bankers, and HR professionals that work in your specific area. Think back to most of the jobs you have gotten and you will probably learn that most of them came through a referral or some other connection that you knew or someone you knew knew, and so on (Think of the idea behind LinkedIn's 3 levels/degrees of connection).

Startuply | StartupHire | VentureRocket | HackerNews | VentureLoop | Indeed | SimplyHired

VII) Internet & Tech Company IP Protection

So you are working on the hottest new startup and want to know how to protect your ideas when you are out raising money and recruiting new engineers and designers. Here is a brief overview of the types of intellectual property (IP), ways to protect them, and tips for your startup. I will focus on some of the more common issues in internet and tech related companies, although some of these issues appear in other contexts.

Copyrights

Copyright is a protection for original works of authorship that must be tangible. You can't use copyright protection to protect an idea until that idea is put into a tangible form. The most common ideas people have of copyright is usually with authors who write film scripts or books where they often see the words "copyright" or a c with a circle around it and things like the name of the author and year next to it. The idea of the book is not protected by copyright law, it is when the book is written is when it becomes tangible and subject to copyright laws. In the internet and software context, source and object code can be protected under copyright laws if they are an expression of an idea, not if they are simply the idea themselves.

It also does not protect facts or data and the work **must be original**. Say you are using source or object code that is commonly used to create a widget or menu on your website. That common code is probably not protected under copyright law as it is not original, but the selection, arrangement, and presentation of each element put together to create your website or e-commerce site may be protected.

Most internet related issues will come under the purview of the Digital Millennium Copyright Act (DMCA) in the United States, but may also include areas from the Copyright Revision Act of 1976. The person who creates the work is generally considered the owner as soon as the work is created; however, the main exception in the tech context are works made for hire. If you hire a developer to design and create the back end code for your e-commerce site, the general rule on ownership of that back end comes down to whether the work was made for hire. If you hire a company or independent contractor to create it, they will likely own the rights to it; however, if you hire an employee to develop it, your company will likely own it. There are very specific tests to determine whether it is an employer-employee relationship and it is not as simple as putting into a contract that the person is an independent contractor. You will need specific legal guidance in this area and the value of these works could be too valuable to not hire an attorney. You can have a contractual agreement regarding the ownership rights of any works developed, but again, something that is best handled by an experienced attorney.

In order to protect works under copyright law, you do not have to publish or register the work with any agency as your rights would attach upon creation; however, it is best practice to include a copyright notice to make others aware of your rights. It is also a good practice, in some cases, to register the work with the U.S. Copyright Office as it gives you better chances in court to protect your works and other advantages. There are costs involved and if there are revisions made to the website or code, it may be too time consuming and costly to keep registering the newest version and the company may not want to disclose some specific information they want to keep confidential.

Patents

A patent is a form of protection for the actual idea behind an invention, which must be new or novel. There are too many specifics of patent law to get into the details, but there are many different types of ideas that can be patented, for example, many software companies do get issued patents on their software (code). The process generally involves filing a patent application with the U.S. Patent and Trademark Office (USPTO). It can be filed at various stages of the idea's development, both prior to, and after use of the patented idea; however, failure to file the patent application and beginning to use the idea in commerce can result in all kinds of legal issues that can end up in court for many years, so it is usually best to file the application early on. Also, just filing the application is not an automatic guarantee of protection. The USPTO goes through a process of review before it actually issues the patent, so it may take time before you can be sure if you have that form of protection or not. You will often see products out there with something on the packaging that says "patent pending" meaning they (hopefully) filed a patent application, but it has not yet been issued to give them full patent protection.

You also have to prosecute your patent to protect from infringement, even if you have a validly issued patent. No one is going to do it for you and the company has to incur the costs of making sure no one is infringing on their patent. Again, similar to copyright notices/markings, it is not required, but usually a best practice to include some form of notice of a patent application being filed for the particular product if it is already launched and being sold or marketed. There can be significant costs involved to file the patent properly, so an attorney who also has the additional distinction of being a "patent attorney" qualified through the USPTO should be consulted to see what kind of costs will be involved and the time frame for filing. There are also "patent agents" qualified through the USPTO; however, they are typically not licensed attorneys and, if not licensed, cannot give you legal advice.

Trade Secrets

Trade secrets are most commonly protected under various state laws and in California, a trade secret is information with value kept secret within and used by a business and the fact that it is secret gives the owner an advantage or benefit. Trade secrets, copyright, and patent protection sometimes overlap and there are strategies involved in using patent, trade secrets, or copyright protection, so it is best to consult with a qualified attorney to make that determination. Often, tech companies don't like the fact that a patent is a public filing and prefer to rely upon trade secret protections, since it does not involve a public filing or application. Once the idea becomes publicly available, you often lose any potential trade secret protection outside of copyright or patent protection. Some common forms of trade secrets are recipes, processes, customer lists, and business plans. In the tech community, a trade secret may not be the actual software code, but the idea or way that the software runs may be.

Trade secrets are protected so long as they remain confidential. The biggest problem is when someone with knowledge of those secrets quits or is fired from a company. In California, the law is on the side of allowing former employees the right to earn a living, which includes protections for the former employee possibly leaving and using trade secrets. This means the company may not be able to go to court to force the former employee not to use the secrets. This is similar to California's significant limitations on contractual agreements not to complete. Companies doing business in California need to be very careful with any trade secrets and not take the policies surrounding hiring and termination of employment lightly. There are a number of measures that should be implemented to protect these secrets such as privacy policies, procedures for departing employees, confidentiality and similar agreements, and limiting the number of people who learn these secrets.

Trademarks

A trademark is an identifier related to a business, product, or other good or service to determine ownership of that mark or name. It can be a company name, a logo, or the way a name is used. **This includes domain names and mere registration of a domain name does not guarantee trademark protection**. The anti-cybersquatting laws were put into place to give some protection against people registering domain names for profit with no intent to use the domain name. Trademarks can be registered on the state and federal level to provide protection through the USPTO or the state agency in charge of regulation. The trademark application is filed and then after a process, a trademark is issued and registered. Trademark applications list certain categories of goods and/or services that the company intends to use in association with the trademark. The common way of marking a trademark to let others know of the company's IP ownership rights are using a super-script TM next to the trademark to signify that a trademark application has been filed, but not formally registered. Once registered and issued, the common form of notice is the R inside of a circle placed next to the registered trademark.

When it comes to starting a business, there are a number of things a company needs to consider. The name of their company, product name, and domain name are all things that may have trademark implications. If a search is not performed to determine if someone holds trademark rights to a new company's name or a domain name, the company can face issues down the road of facing a trademark infringement lawsuit. Even if the company obtains a registered trademark, they still have to continue to keep it current to avoid it being determined to be abandoned and losing their rights.

If another company is distributing a product or service for the owner of the trademark rights, the trademark owner often needs a license agreement to give the other party permission to use the trademark in advertising or product packaging, but with limits on use and other specific contractual conditions. When using another company's trademarked name or other IP on a website or within code, the company needs to be sure that they have the right to use the trademark or obtain consent from the owner of the trademark to avoid claims for trademark infringement.

There are many factors to be reviewed in technology and internet companies from their formation through product development, growth, and exit transactions that have intellectual property implications. The company definitely needs to consider many of these issues at all stages and if nothing else, needs policies and confidentiality agreements to use to try to protect its ideas and developments (or anything else that may have existing or future value to the company). For most tech and internet companies (in fact most startups early on), their intellectual property is often the only thing of value that they have, so it is critical to be sure the proper protections are in place. Even in the development stages, disagreements can arise as to who developed/designed and owns what, so agreements should be in place to deal with those types of issues before things go bad and end up in court (e.g. Facebook's early years).

Privacy Policies, Terms of Use, End User Licenses

These are important issues that need to be looked at to protect the company's IP and its business in general. They are covered in the section on Online Contracts & Policies.

VIII) Valuation

Common models used to value a company, how these apply to startups, stock valuation, stock option valuation, and comparisons with US GAAP accounting valuation.

Common Company Valuation Methods

Market Capitalization

Most people are familiar with terms like "market cap" if they have any interest in publicly traded stocks. Market capitalization is a method that can be used to value a company by taking the number of shares of stock issued and outstanding times the current stock price listed on whatever exchange they are traded on (e.g. Microsoft trading at $30/share X 8.39 Billion Shares Outstanding = $251 Billion Market Cap). The problem with this method is that it varies so widely based simply upon the free market's trading and can be easily affected by institutional investors and brokers buying and selling in large blocks at certain times of the month, quarter, etc. Just because the market is willing to pay $30 per share for a share of stock, that is only an indicator of what the fair market value is of that share of stock. This can sometimes be based upon speculation, recent news, or other factors that really don't accurately tell someone what the actual business is worth. The biggest problem for startups or small emerging growth companies is that they are almost always private and do not have a fair market value for their stock to use for this calculation. You can look to recent private sales of stock to show what those investors were willing to pay, but that is not a predictor of what the market in general may pay for the stock. This is why it is hard to predict exactly where an IPO per share price will end up after the stock starts trading and settles into a trading range.

Book Value

Another method is to look at what the company's book value is, i.e. what does the company's balance sheet show for its assets minus its liabilities (which is the same as owner's equity). The difficulty in this method is that it is looking simply at almost a liquidation type of scenario and doesn't take into account things like future business deals, revenue growth, and other aspects of a business. The main difference from liquidation value is that it uses the booked amount of value for an asset versus the current fair market value of that asset. It also relies upon the company's accounting records being accurate and using proper ways to record the value of certain assets and debts, such as the wild variations in how certain intellectual property value might be shown. For example, trade secrets, business methods and business contracts are often not booked as an asset, but clearly hold value for a business or a patent could be booked based upon the cost to acquire or apply for the patent, which doesn't always show the true value of the patent.

Discounted Cash Flows

A traditional and common finance valuation method is discounted cash flows, where you are looking at the current value of future cash coming into the business. The reason it is "discounted" traditionally is because cash in the future has a different value than cash right now and there are issues of risk and projected rate of return, so it adjusts future cash and comes up with the current value of that future cash. Traditional time frames used for the cash flow calculation vary, but are usually in the several year time frame (3 to 5). You could also use a similar free cash flow to equity calculation which is the current value of cash available (using discounted cash flow calculations) to pay to equity holders less the costs of paying off debts.

Enterprise Value

Enterprise value takes a modified form of market cap to adjust for the company's debt. It is most commonly thought of as what are the total costs to acquire the entire enterprise, i.e. purchase its stock, pay off its debts, etc. This might calculate acquisition costs, but it doesn't tell the investor what their stock would be worth since it includes debt.

So what is the best valuation method, there is no one right answer. For a new company, the investor generally wants to know what their investment will be worth in a certain time frame. You can show things like comparisons and analysis to other companies in a similar industry as a basis for calculations. You would need to find public companies in the same industry to find information like price-to-earnings multiples or other common valuation metrics. In the end, you need to look at projected cash flow and how that will translate into an increased investment for the investor. If the company already has revenue, it can show things based upon prior earnings and projected growth of those earnings, but most startups need to simply rely upon their own projected value method since they are pre-rev. The key when raising money is to understand that the way you value your company could vary widely from what an investor thinks is the best way. You need to be sure to document the assumptions that are the basis for your valuation calculation and compare different scenarios so that when an investor asks you what would happen if X or Y happens, you have a way of explaining how different variables would affect your business' bottom line and their eventual investment.

Stock Option Valuation

Many people want to know what the stock options they got or may get with a company are worth. Again, there are different methods to determine value, but they usually involve the current fair market value of the underlying stock issued upon exercise. (A stock option grant is a contractual right to purchase a number of shares at a set price and to "exercise" this right means you are purchasing a certain portion or all of the stock grant). The traditional method now used by most companies is called the Black-Scholes Option Price calculation, although some companies use what is called the binomial model. It is a somewhat complex calculation and is used to assign a value to the stock options that needs to be recognized by the company as compensation expense for accounting purposes. For an employee, they are not as concerned with how the company accounts for the option, but what it is worth to them now. The company needs to keep track of these things for tax purposes and securities law compliance since a certain level of option grants can result in securities law reporting issues. You can find lots of online calculators that will calculate this for you.

The easiest way for an employee to think of the value of the grant is to compare the fair market value of the stock with the exercise price listed in the grant. For example, if the stock is worth $10 per share and the person was granted the right to purchase the stock at $1 per share, the value of an option grant would be $9 per share times the number of shares in the option grant. The obvious problem for a startup or other small company is how to determine the fair market value of the stock or what the stock might be worth in the future. There is no right answer unfortunately. You really have to use your best judgment and look at things like what the most recent investors were willing to pay per share or other company valuations to see what it may be worth. Also, you have to think about the company's future growth as this will raise the value of the stock, and, in turn the value of the stock option grant. There are also issues of whether you can easily sell the stock once you exercise your option and get the stock. There are often legal restrictions on the ability to sell stock and often little to no market exists to but the stock from you. If the company goes public or gets acquired, you will usually have a way to more easily sell the stock within those transactions, but you have to exercise your option by paying the exercise price to get the stock first.

Bottom line for founders or other people getting involved with a startup or other emerging growth company, think about what your time is worth and if you are taking less than your normal hourly market rate, does the stock grant or stock option grant adequately compensate for that difference. You also need to think about the opportunity cost of putting your time and effort into a company when you could be working for just cash or for another company. There are risks that you might not realize any value from the option (company goes bankrupt, no public market to sell the stock, or you are restricted from selling it for 90 days, a year, or more). You also have to come up with the cash to exercise the grant unless the company is willing to do a net issue exercise (also called a cashless exercise), which means the number of shares goes down to adjust for the fact that you are not putting in the exercise price in cash.

The main things to look at in an option are:

- Current fair market of the company's stock & projected future growth of the company's stock
- Exercise price, as compared to current or future price of the stock
- Number of shares
- Vesting schedule- you only gain the contractual right to exercise the option after the stock has "vested", so most grants vest over a period of time to insure the employee stays with the company long term
- Maturity, duration, or termination- A stock option right is not granted forever. There will be a limit on when you can exercise the option and if you fail to do so in that time frame, you lose the right to that option grant. Employees should also look to see what happens if they are terminated from or quit their employment. Many option plans state that a terminated employee has a short period of time to exercise their option rights or they lose them (in some cases 30, 60, or 90 days).

- Tax issues- This section is too general to get into the specifics of tax consequences, but the employee should look into what effect the option grant, exercise, and eventual sale has on their personal taxes. They also need to see if the option qualifies as an incentive stock option (ISO) or non-qualified stock option (NSO), as that can make a difference in tax consequences.

Additional discussion of stock options is also included in the section on Compensation.

US GAAP Accounting

There are a set of standards used by the accounting and finance community for how to deal with valuation and other value issues. The company needs to keep their books according to the standards and rules set out in the U.S. generally accepted accounting principles (US GAAP) for a variety of reasons, especially for a future IPO or tax reasons. These strict rules set out the way a company keeps its books and can have differing rules for recognizing revenue, valuing a patent, or other items. You need to understand that US GAAP accounting may show a value for something like a stock option or patent application that is wildly different than what it may actually be worth to someone. When dealing with valuation of a company, US GAAP does not have to be used in most cases, but a basic understanding on how it may be different can be helpful. When you read publicly traded company financial statements, most sections will be prepared according to US GAAP and any exceptions will usually be explained, disclosed, or listed in the footnotes to the financial statements.

Sometimes US GAAP can affect employees. For example the financial accounting statement number 123 (FAS 123) promulgated by the financial accounting standards board (FASB) was changed within the last few years to allow for better tax treatment in dealing with exercise of stock options and can affect whether a company may want to allow net issue exercises.

IP Valuation

One major problem for tech companies, especially those dealing with new technologies or developments is how to value the intellectual property of the company. There are ways of valuation for conservative accounting purposes, but the new company often wants to find ways to show higher value in order to raise money. There are three main methods of valuation: i) market approach- looks to the market and compares your product or service with something similar to come up with ideas on what your idea is worth, ii) cost approach- what did it cost to acquire or develop the IP, in other words, what would it cost to replace or reproduce it, and iii) income approach- this estimates the future benefit of the IP. Often the income approach is more speculative, but tends to lead to higher valuations, but only for income producing IP. So if you predict that a patent will lead to a marketable product, what will be the future revenue from that product and what is that worth now. However, this approach may not work if an item of IP, such as a trade secret or business method may not be tied directly to revenue. The common forms of the income method you may hear about are relief from royalty (how much would the company pay in royalties if it used, e.g. licensed the technology from someone else), Greefield (this uses traditional discounted cash flows to estimate future cash flows from only the IP), excess earnings (what amount of additional excess cash would be generated by the IP), or lost profits (difference between profits with the IP versus profits without the IP).

There are many forms of valuation and the specific application will determine which method may work best. Obviously most startup or emerging growth companies want a high valuation, but the key to handling investor questions is to thoroughly work through the best methodology and be able to explain the underlying assumptions of how you ended up with your current valuation. If all of this discussion sounds completely foreign, find a good finance person to help you, such as an interim CFO, even if it is simply to prepare financial projections or valuations.

IX) Term Sheets & VC Finance Documents

A term sheet is a commonly used tool in the financing of a new or growing company, although term sheets are used in many other types of transactions or negotiations (sometimes called memorandum of understanding (MOU), memorandum of terms (MOT), letter of intent (LOI), and other variations). Basically, a term sheet is a written mini-agreement between the parties to try to get on the same page. I explain it to clients that it may involve some costs and time for an attorney to help put this together, but it can eliminate or cut down on some misunderstandings and items of disagreements. The company will put down some of the material, i.e. major, proposed terms of the agreement the parties are trying to reach, write them into a written term sheet, and sign the document before moving any further in negotiations. This can significantly reduce costs in the long run because many times parties realize when they are paying attorneys to draft a lengthy agreement that the two sides don't actually agree on some deal breaker points.

There are strategic issues involved and decisions to be made on whether to require a term sheet early on because many startup or small companies are afraid to ask a potential investor, VC fund, or other financing source to sign something very early on in the process. That is a decision that each company's management must make, but you are usually better off having one and most investors are very familiar with term sheets.

Here are some common aspects of term sheets that need to be considered when dealing with financing of a business:

- Current and future capitalization of the company, including any outstanding options or other grants that could affect these number (this and the next bullet point usually come down to valuations of the company)
- Amount invested, number and class of shares and per share price if equity finance, or amount loaned and terms of loan repayment if debt finance
- Dilution- Will there be any anti-dilution provisions for the investor and what type of anti-dilution protection?

- Future capital issuances- Is the company reserving some equity or stock options to grant to employees, directors, management, or otherwise?
- Will the investor have rights to dividends or what is the company's dividend policy?
- Does the investor have any liquidation preferences or rights in the event of winding up or bankruptcy of the business?
- Does the investor have any conversion rights to convert their stock or debt into some other interest in the company (e.g. convertible preferred converts into common stock) and what are the conversion ratios and other terms? Are there any rights of redemption (repurchase of their stock by the company)? What are their voting rights? What are their rights to information about the company?
- When dealing with a potential exit transaction by going public, what are their registration rights to have their stock registered to be more liquid? Will their be a lockup agreement and what will any lockup or market standoff agreement look like?
- Do they have rights in future raises, such as rights of first refusal or co-sale agreements?
- Will they have rights to place someone on the board of directors or into management?
- What are the terms for existing stock, options, etc? For example, are the founders shares subject to vesting to give them an incentive to stay with the company?
- What are the confidentiality provisions that the parties are subject to during the negotiations?
- Is the term sheet exclusive and does it terminate at a time or upon an event? Can the company agree to funding from other sources while still in negotiations with another investor?
- Payments from the funding are sometimes included, such as who chooses and who pays the attorneys who close the deal and if there was anyone who will be paid a commission, are they licensed and registered broker/dealers (See Section on Finder's Fees)?

Term Sheet Resources / Generators:

There are existing term sheet resources and term sheet generators with standardized forms on the web, some of which are listed below by hyperlink to outside websites. These documents and resources should not be a substitute for legal advice. They are meant to be educational in nature and, if they are used, are customized by the attorneys involved in the transaction. No representations, warranties, or guarantees are provided as to their content or use and use of these resources are subject to the outside website's terms & conditions of use, including trademark and copyright laws.

Wilson, Sonsini, Goodrich, & Rosati Term Sheet Generator (Subject to listed terms of use)
http://www.wsgr.com/wsgr/display.aspx?sectionname=practice/termsheet.htm

Orrick, Herrington & Sutcliffe LLP Term Sheet Generator (Subject to listed terms of use)
https://tsc.orrick.com/

Series Seed- Standardized Sample Documents for Venture Capital Financing (Subject to listed terms of use)
http://www.seriesseed.com/posts/documents.html

National Venture Capital Association Model Venture Capital Financing Documents (Subject to listed terms of use)

http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136

Blog Posts and Articles with inside perspective and focus on startups and venture capital:

http://cdixon.org/contents/

X) Exits- IPO, M&A, Reverse Merger

Many people start companies because they are passionate about their idea, product, or vision. Investors love to see that passion in a founder, but they are obviously wanting a return on their investment. This is where exit strategies come into play, sometimes referred to as a liquidity event. You could lump things like a dividend distribution or repayment on a note in as a form of exit for the investor to recoup their investment and gain their return; however, most early investors in startups are willing to take the very high risk of failure for that investment in return for a potentially large return on their investment and dividends are not usually as sexy of a return.

Mergers & Acquisitions

Common forms of exit are to merge with another company or be acquired (i.e. bought) by another company. Of course, a startup could also seek out acquisition targets to obtain their intellectual property or their management team and be the one doing the buying, but we will look at M&A from an exit strategy point of view for the selling company.

Acquisitions typically come in one of two forms, a stock purchase or an asset purchase. They are pretty self explanatory, in one the acquiring company buys all the outstanding stock to acquire control of the seller, the other the buyer simply purchase all of the selling company's assets and the selling company simply dissolves. There are a number of factors involved in making the decision of whether to utilize an asset sale or stock sale as the preferred method for the transaction, such as taxes, accounting, anti-trust, securities laws, liabilities, contract rights, and practical or logistical considerations.

Since these types of transactions usually require some form of majority vote of the shareholders, there are considerations such as dissenting shareholders' rights or accounting rights if the shareholder refuses to vote for the M&A transaction.

All of the above considerations also go into whether to choose a merger instead of stock or asset sale. A forward merger is treated similar to an asset sale and reverse merger treated similar to a stock sale. A merger, stock sale, or asset sale can result in a liquidity event for investors, but not all the time.

The major factor for an investor is obviously the valuation of either the stock or assets of the company to see what their return will be.

IPO or "Going Public"

Many people don't understand exactly what it means to "IPO." An initial public offering (IPO) is when a company registers their stock with the SEC and also sells some or all of the stock they are registering to the public to create a public marketplace for the purchase and sale of their stock. Various federal and state securities laws place significant restrictions on transfer of private stock, but allow stock to be publicly traded between individuals once the stock is registered with the SEC. The registered stock is then listed for sale on some form of exchange, such as NASDAQ or NYSE, or electronic marketplace, such as what are referred to as "Pink Sheets" or "Over the Counter Bulletin Board" marketplaces. This provides a marketplace for average people to buy and sell that company's stock. In the IPO typically an investment bank comes in to sort of pre-market the company's stock before it is actually publicly traded to get a sense for what the right price is and how much stock would be bought once it hits the market. So not only does the IPO process register the company's stock, it creates a public marketplace for resale, and raises money for the company. Prior investors typically have registration rights before the IPO so that their stock is registered in the process and able to be sold, thus recognizing an exit.

Until the shares are registered, it is difficult for someone owning shares in a startup to be able to easily sell their stock due to restrictions on transfer and the fact that there is no public market to sell the stock in. They have to try to do private sales and comply with securities laws or exemptions to allow the sale. In many cases under Rule 144, they have to own their stock for a period of years before they can sell it.

So why doesn't every company simply pursue an IPO right away? The IPO process involves filing a registration statement, typically an S-1, with the SEC. This document gives all kinds of explanations about the company, its financial performance, management team, and business plans for the future. It also provided financial statements and other required disclosures. In order to produce an S-1, auditors and lawyers need to be hired to audit financial statements, provide legal opinions, and assist with drafting the S-1 (See my discussion and links to Facebook's S-1 as an example). The SEC then will often have comments or request further information regarding the S-1 requiring the company to amend their S-1. Often after several months, the SEC then declares the registration effective and the stock is registered. The expense and time involved in this process can be tremendous, often costing from several hundred thousand dollars to several million dollars.

The other factor involved is the actual sale of the stock. Many investment banks will enter into fee agreements that are a percentage based on money they raise, so it may not cost the company anything up front. However, any major investment bank is not going to simply take on the IPO process for a no-name company because they want to know that there will be buyers out there willing to pay their asking price. The market, investment bankers, and company want to be sure there will be enough liquidity (purchase and sales) in the marketplace to create a regular market. Many stocks have gone public only to see the market for their stock drop to where there is so little volume (no buyers) that the stock price drops into the pennies per share. These so-called "penny stocks" end up on the OTCBB or Pink Sheets with very little trading volume, so no current shareholders can even sell their stock on that public market.

Reverse Merger

There was a time when the new method to avoid the costs of going public was to do a reverse merger where the company merges into an already publicly traded company and takes over that company. The private company exchanges its stock for the public company's stock and like that, it is a publicly traded company without the need for the traditional IPO. The shareholders go from shares in a private company to shares in a public company in a very short time. This process sometimes involved cash changing hands, but was usually simply a transaction used to go public, not necessarily raise money. The SEC cracked down over the last several years on the practice of using so-called "shell companies" that would go public by registering shares with the SEC and then simply not conducting any business and sell their "shell" to a reverse merger candidate who wants to quickly go public. The reverse merger process is still something that can be used to create liquidity, but the limitations placed by the SEC place some obstacles to using this as a legitimate form of going public. Essentially, the public company should not just be a shell formed for the purpose of avoiding the initial share registration process. If it was actually an operating company that simply failed, but was still publicly listed, it still could be used for a legitimate reverse merger.

So a reverse merger can be included as a "going public" type of transaction to get liquidity or an exit for existing investors, but the more traditional forms of exits are IPO, traditional mergers, and acquisitions. There are other creative ways to provide an investor an exit that can be examined such as new investment rounds purchasing some of the prior investors shares, company repurchases of shares, and others. The bottom line is that every founder should analyze and be ready to discuss a proposed exit with investors; however, investors want to hear your passion for your idea and execution on it, not that you can't wait to go public or be acquired and get rich.

XI) Online Contracts

Here are some of the specific issues faced by SaaS, cloud computing, social networking, and other online service companies.

Online E-contracts

One of the common questions in dealing with tech companies deal with legal and contractual questions when you don't have an actual customer sitting in your office that you make a deal with and sign a physical contract with. On the web, these take the form of those long and wordy pop-ups that everyone usually just clicks "okay" to and moves on; however, those are often legally enforceable agreements. There are a number of laws that deal with related issues too lengthy to go over here, but the main ones are the Electronic Signatures in Global and National Commerce Act (E-sign), Uniform Electronic Transactions Act (UETA), and the Uniform Computer Information Transactions Act (UCITA). The intent of these laws is to have certain requirements that need to be met for websites, online e-commerce, or social networking sites to utilize in order to have a valid and enforceable contract. The requirements are too specific to go over in detail, but this is a very important area to have a qualified attorney if any part of your business relies or will rely upon electronic agreements. If you comply with these requirements, yes, those common terms and conditions and other forms that you click on can be validly executed contracts.

Online contracts often involve or require items like an end user license agreement or similar license agreement, terms of use, privacy policies, and links policy or agreements.

End User License Agreement

Although there is a separate section discussing License Agreements, the end user license agreement (EULA) is appropriate to discuss in this section.

The EULA or a similar type of software use license agreement is a very important document to protect the company's IP and try to limit any potential lawsuits down the road. These need to cover certain areas that are covered in traditional license agreements, but also relate to the issues related to software, code, and the electronic nature of the agreement. Failure to properly license certain items of intellectual property could result in loss of ownership rights.

Open source licensing can present its own set of unique problems. Simply because the company believes it is giving free access to its code, it doesn't mean that they should not worry about legal issues and consult with a qualified attorney.

Terms of Use

Every website or online business should have policies and procedures in place, not just for their physical operations, but also for their online commerce and interactions. Clearly displaying your company's terms of use is very important. There are a number of provisions which should be included, but again, these are legal documents to protect the company and a licensed attorney should be consulted to, at a minimum, review your terms of use before launch. These clauses deal with things like who owns rights to the site's content, are there trademark or copyright rights being asserted, are you granting a limited license right to the user and what are its terms, and descriptions of what services you are providing.

Privacy Policy

Just like a website or online company should have some form of terms of use published, they should also adopt and display the company's privacy policies. This is another protection for intellectual property and to avoid potential lawsuits related to confidentiality and privacy. Most of the time the privacy issues are covered in the EULA or other licensing agreement used, but the site itself should have a general privacy policy. In California, commercial websites doing business in the state are required by law to have and post a privacy policy online.

The main concerns that need to be covered are things like what personal information may be collected through forms or cookies, how is that information used (is it sold to a third party), how is it stored and protected or destroyed, and how to handle children's data.

Dealing with Links or Others Content

Various laws such as copyright may come into play when dealing with outside websites or content. You cannot simply start copying content or placing links on your own website in many cases without the express written consent of the company or person who prepared and published the information. As discussed in the section on IP protection, there are various copyright, trademark, or other legal ownership rights that may attach and use or reproduction without consent may result in infringement. This can also apply to something as simple as a picture on a website that you copy and use on your website. Just because something is in the public domain, it doesn't mean anyone can copy it. Think of a website as a movie or book, you can't start making copies of part of it and using them to profit without generally violating various IP laws and in some cases, criminal laws. This can include downloading content like music or videos. In most cases, hyperlinks alone will not be ruled to constitute copyright infringement, but you should still be cautious and seek written permission first.

XII) Licensing

A) Traditional Licensing:

A license is when someone who owns or has rights to certain intellectual property grants a right to someone else to use that IP under certain terms, conditions, or other restrictions. A license is usually put into written form of an agreement that sets out exactly what the IP is and what rights are being granted. This is to be distinguished from an outright sale or assignment of IP, which is normally a different kind of written agreement.

The best features of a license are that the company maintain certain controls over its property to be sure that they are not used improperly and try to assure that they continue to get revenue or royalties from the future use of the IP. This can be valuable in protecting distribution rights. Also, in software applications, the company can control more of the confidential trade secrets within the coding or design of the software. It is a good way to try to prevent reverse engineering or unplanned uses of the software. There are certain advantages in terms of maintaining control of the software and deriving additional revenues from things like additional user licenses and updates or revisions to the software. A little more detail on the revenue applications and differences will be discussed in the section on SaaS.

A certain amount of confidentiality is key to license (and many other tech) transactions. Most companies will utilize some form of written non-disclosure agreement (NDA) or confidentiality agreement, even during the preliminary negotiations and obviously within the actual license agreement. Here are a few key areas that will need to be addressed:

- Need a clear definition of what exactly the intellectual property is?
- Who actually holds the rights to the IP? Is it the company or sub-licensed from another party? Is there a patent or patent application or other filing that covers it?
- Terms of the grant? Exclusivity, geographic limitations, use limitations, length of license grant, any rights to sub-license, who owns improvements of the IP?
- What are the payment terms? Is there an up front down payment, how are royalties or future payments calculated and when?

- What does the licensee (one granted the license) have to do to maintain the confidentiality of the IP and related trade secrets?
- What rights does the licensor (one granting the license) have to get regular reports necessary to calculate royatlies and any rights to inspect the books of the licensee to assure accurate reporting?
- What happens if there is a dispute and how will it be handled?

B) SaaS Licensing:

SaaS stands for software as a service. There are starting to be more and more similar acronyms for other services, AaaS (architecture as a service), BaaS (business as a service), IaaS (infrastructure as a service, often used in cloud computing), and so on.

SaaS license agreements generally fall within the end user license agreements covered within the Section on Online Contracts.

C) EULA (End User License Agreements)- Although considered a license agreement, they are dealt with in the section on Online Contracts.

XIII) Technology Assignments & Sales

What is an "assignment"?

An assignment is when you transfer property rights from one party to another. In tech transactions, it may be something like a purchase of some form of intellectual property like a patent for cash; however, an assignment can take many different forms. For example, a founder of a company may transfer their rights in a patent for an invention that they developed in exchange for their initial stake in the newly formed company. Many people don't realize that there are steps that need to be taken to transfer ownership and, in most cases, they can't take the property back just because they want to leave the company. This is where an assignment comes into play and should be put into a formal written agreement assigning the rights. These agreements commonly are included within a purchase agreement or as a separate written agreement in connection with purchases and sales of companies, or individual items of property. They are included to be sure that the transfer of ownership is properly documented. They can be used for things like physical assets, like a car, but they become even more valuable when you are dealing with assets that are intangible like trade secrets, trademark rights, or patents. When you sell a car or inventory, you can move the physical property from the seller to the buyer, but with intellectual property, there is often nothing physical to give to the other person.

Patent, Patent Application, Trademark, & Trademark Application Assignments

Patents are something that does have some form of ownership documentation in the form of a patent application or the actual issued patent from the US Patent and Trademark Office (USPTO). It becomes necessary to not only put together an assignment agreement, but also take the required steps to be sure the patent or patent application is transferred through the proper channels, such as the USPTO. Here is a sample of what an issued patent cover page and patent assignment form looks like:

Docket Number (optional)

ASSIGNMENT OF PATENT

Whereas, I, ______________________ of ______________________ hereinafter referred to as patentee, did obtain a United States Patent for an improvement in ______________________

No. ____________, dated ____________; and whereas, I am now the sole owner of said patent, and,

Whereas, ______________________

of ______________________

hereinafter referred to as "assignee" whose mailing address is: ______________________

City of ____________, and State of ____________

is desirous of acquiring the entire right, title and interest in the same;

Now, therefore, in consideration of the sum of ________ dollars ($________), the receipt whereof is acknowledged, and other good and valuable consideration, I, the patentee, by these presents do sell, assign and transfer unto said assignee the entire right, title and interest in and to the said Patent aforesaid; the same to be held and enjoyed by the said assignee for his own use and behoof, and for his legal representatives and assigns, to the full end of the term for which said Patent is granted, as fully and entirely as the same would have been held by me had this assignment and sale not been made.

Executed this ____________ day of ____________, 20________,

at ______________________

____
(Signature)

State of ____________)
County of ____________) SS:
Before me personally appeared said ____________
and acknowledge the foregoing instrument to be his free act and deed this ______ day
of ____________, 20________

Seal ______________________
(Notary Public)

Trademarks and trademark applications are also documented with filings with the USPTO. There are also steps that should be taken to show transfers of ownership similar to patents. Here are sample trademark

When putting together trademark or patent assignment agreements, it is critical that the buyer conduct their due diligence to be sure the seller has full rights to sell the patent or trademark. The buyer needs to be sure the patent or trademark is still valid as the owner needs to take steps to "prosecute" their patent or trademark to avoid infringement by others or defend potential infringement claims against it. Also, just because a person has filed an application for a trademark or patent, it does not guarantee the application will be granted. It is not as simple as going online to search on the USPTO website to see the status of an application as not all applications are publicly available and if you aren't experienced in the process, you may not be able to understand where the application process is at. There are state and international law issues that could come into play and an experienced attorney in this area should be used to assure you protect these valuable assets and get what you are paying for in a purchase transaction. The due diligence should also include researching into whether there may be any liens or security agreements that could be using the patent or trademark as collateral, which could result in the buyer not obtaining full rights.

Domain Name Assignments

Most people in tech are familiar with ICANN for domain name registration. In addition to ICANN, domain names are protected under trademark or service mark laws. Disputes for domain names are typically subject by ICANN to the Uniform Domain Name Dispute Resolution Procedure (UDRP). In addition, the federal Lanham Act and Anticybersquatting Consumer Protection Act (ACPA) deal with protection of domain names as trademarks. Mere registration with ICANN does not automatically guarantee any trademark law protections. Due diligence in a domain name purchase or other transaction needs to include research into who the registrant of the domain name is and whether any trademark applications based upon the domain name may have been filed or an actual trademark issued. In addition, counsel should be sought as to whether the sale of the domain name may be a violation of the ACPA.

Trade secrets and other intellectual property assignments

Other forms of intangible property can be transferred through use of an assignment agreement and most company stock or asset purchase agreements will include clauses or a separate agreement that assign any possible intellectual property to the purchaser. So even if no actual patent, trademark, or application for those have been filed, it tries to assure other things like ideas or developments made by the seller are covered and transferred to the new owner.

Technology Purchase & Sale Agreements

Assignments are commonly associated with intellectual property agreements, such as purchase and sale as discussed above. There are a number of factors to be considered when negotiating and drafting tech purchase agreements and are too numerous to discuss in detail and a qualified attorney should be consulted to handle not just the basic purchase agreement, but dealing with all of the IP that is involved and many companies may not even be aware of.

All of these are complex legal issues and consulting a local licensed attorney familiar with all these issues can be invaluable.